

# India's Free Trade Agreements

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## Abstract

This paper reviews India's experience with the free trade agreements (FTAs) that it signed over the last two decades. The trade outcomes under the agreements are found to be quite modest: The trade shares of India's FTA partners stayed nearly constant over the past decade, and trade deficits with FTA partners, as a share of the overall deficit, did not increase over time. These findings challenge the assertion that India's trade agreements have led to a widening of trade deficits and that they were responsible for the stagnation of the Indian manufacturing sector.

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## I. Introduction

A cornerstone principle of the General Agreement on Tariffs and Trade – World Trade Organization (GATT-WTO) system, which has overseen international trade relations between countries since the end of World War II, is the principle of non-discrimination. As established in Article I of the GATT, member countries may not discriminate between “like products” from “different trading partners,” that is to say that imports must receive the same treatment regardless of the country of origin. However, in an important exception to (and derogation of) Article I, the GATT, through Article XXIV, permitted preferential treatment in trade, through the formation of free trade agreements and customs unions, provided these agreements result in comprehensive liberalization of ‘substantially’ all trade between the member countries. Subsequently, through an “Enabling Clause,” introduced in 1979, the GATT permitted developing countries to enter into preferential agreements with each other in a manner that did not require the comprehensive liberalization mandated by Article XXIV. That is, under the Enabling Clause, partial liberalization of trade between “developing” and “least developed” member countries was permitted.

Prior to the 1990s, there were merely a handful of preferential trade agreements (PTAs) in force. However, with the perceived slowdown of the WTO process, and the abandonment of the principle of non-discrimination in favor of preferential trade by major players - such as the United States<sup>1</sup> - many countries have found it more attractive to negotiate trade treaties bilaterally, or with small groups of countries, rather than by substantially engaging the multilateral process. Such preferential agreements are now in vogue, with hundreds of GATT/WTO-sanctioned agreements (of both the Article XXIV and Enabling Clause variety) having been negotiated during this period. Nearly every WTO member-state is party to at least one PTA, and the average WTO member-state is party to over seven agreements.<sup>2</sup>

In recent years, India has negotiated a number of preferential trade agreements.<sup>3</sup> Some of these agreements are bilateral, while others are plurilateral agreements, signed with multiple countries. India’s bilateral agreements are with Afghanistan, Bhutan, Chile, Japan, Malaysia, Nepal, Singapore, Sri Lanka, Thailand, and the Republic of Korea. India has also entered into plurilateral agreements with the Association of South-East Asian Nations (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam); the MERCOSUR countries (Brazil, Argentina, Uruguay, and Paraguay); the Asia Pacific Trade Agreement (APTA) involving Bangladesh, Sri Lanka, China, Korea, and Laos; and the South Asia Free Trade Agreement (SAFTA) involving Afghanistan, Bangladesh, Bhutan, Sri Lanka, India, Maldives, Nepal, and Pakistan.

The impact of these trade agreements on trade outcomes has been of significant interest in policy circles in India. It has been suggested that India’s agreements led to a substantial widening of India’s trade deficits - an argument that appears to have driven, in some measure, India’s recent decision to withdraw from the Regional Comprehensive Economic Partnership (RCEP). A recently concluded trade agreement involving a large number of countries in Asia, RCEP will likely be the largest preferential trading bloc in the world (including essentially all of the ASEAN nations, along with China, Japan, Korea, Australia, and New Zealand).

Have such trade agreements indeed worsened India’s trade imbalances? Is the potential worsening of the trade deficit a reasonable concern for India to have in the context of agreements, such as RCEP, that it might yet sign? This paper explores trade outcomes under India’s trade agreements from the years 2007-2017 with the goal of addressing these questions.

## II. Trade Outcomes Under India's Trade Agreements

A frequently expressed concern regarding India's trade has to do with its external balance, in particular, that India's trade deficits have widened over the last decade. Relatedly, it has been argued that India's previous trade agreements have contributed significantly to an expansion of its trade deficits with its partner countries (and that this will also be the case with any future agreements, such as RCEP).

While India's current account deficits did widen over the last decade in dollar terms, any student of economics would point out that the current account deficit is exactly equal to its savings-investment imbalance - and not, in the first instance, driven by trade policy.<sup>4</sup>

**Table I: Trade shares with partner countries**

	2007			2017		
	Import Share	Export Share	Trade Balance Share	Import Share	Export Share	Trade Balance Share
India-Bilateral	13.3	13.7	12.6	11.8	14	7.5
India-Afghanistan	0.3	0.1	-0.19	0.09	0.21	-0.15
India-Bhutan	0.09	0.04	0.18	0.05	0.13	-0.13
India-Chile	0.86	0.15	2.27	0.25	0.25	0.63
India-Japan	2.7	2.2	3.5	2.3	1.52	3.9
India-Malaysia	2.6	1.27	5.3	2	1.8	2.2
India-Nepal	0.2	0.8	-1	0.09	1.8	-3.4
India-Singapore	3.1	4.3	0.7	1.6	3.9	-2.9
India-Sri Lanka	0.2	1.7	-3	0.15	0.15	-2.5
India-Thailand	1	1.1	0.7	1.4	1.2	1.9
India-Republic of Korea	2.5s	1.7	4	3.6	1.5	7.8
India- ASEAN	9.6	9.5	9.9	10.2	12	6.6
Asia-Pacific Trade Agreement (APTA)	2.7	4.8	-1.39	3.9	5.4	10
South Asian Free Trade Agreement (SAFTA)	0.7	5.2	-8.2	0.5	6.6	-11.5
India-MERCOSUR	0.7	1.5	-0.8	1.7	1.3	2.6
India-China	11.2	6.5	20.7	16.1	4.2	39.7
India-USA	6.4	13.7	-8.1	5.4	15.6	-14.6
India-EU	14.8	21.7	1	9.9	17	-4.65

Table I provides statistics on the import and export shares of India with its partner countries, and the change in these shares between the years 2007 and 2017. Data on India's trade with the individual countries with which it has bilateral agreements is aggregated into an "India-Bilateral" category. Table I also provides information on trade trends under India's plurilateral agreements, including with ASEAN and MERCOSUR.<sup>5</sup> Finally, for comparison purposes, the table also provides data on trade between India and the United States, the European Union, and China.

It should be readily evident from Table I that trade between India and most of these partner countries has stayed very steady over the past many years. Consider first the trade between India and its bilateral agreement partners. Overall imports with these countries stood at 13.3% of total imports in 2007 and moved to 11.8% by 2017. Exports to these countries stood at 13.7% in 2007 and moved to 14% by 2017. Trade between India and its bilateral partners has, thus, simply kept up with its global trade patterns. Trade with the larger countries in this grouping -- Korea, Japan, Malaysia, and Singapore -- also looks remarkably steady, especially in the aggregate: the slight increase in import share from Korea appears to be offset by reductions in import share from Japan, Malaysia, and Singapore.

India's trade under plurilateral agreements -- notably India-ASEAN and India-MERCOSUR -- looks mostly steady as well. Trade with ASEAN countries rose slightly (import share rose from 9.6% to 10.2% and the export share rose from 9.5% to 12%). India-MERCOSUR trade rose slightly as well. MERCOSUR's import share rose from 0.7% to 1.7%, and the export share dropped slightly from 1.5% to 1.3% of overall exports. The conclusion here is a straightforward one. India's trade share with its bilateral and plurilateral partners did not rise significantly over the years 2007-2017.

One concern that is frequently expressed in India concerns the balance of trade between India and its PTA partners -- specifically that India's trade agreements have led to an expansion of its trade deficits. However, the data indicate otherwise. Trade deficits with India's bilateral partners accounted for 12.6% of the overall trade deficit in the year 2007. In 2017, they accounted for a considerably smaller 7.5%. Similarly, India's trade with ASEAN and MERCOSUR accounted for 9.1% of the total trade deficit in 2007, which fell to 6.6% of the overall deficit in 2017. Thus, while India's trade deficits widened over the years in nominal dollar terms, PTAs do not account for an appreciably larger fraction of these trade deficit than they did before.<sup>6</sup>

While aggregate trade shares within India's agreements seem relatively steady over time, there is a question of what this looks like at a sectoral level. For instance, are there specific sectors where the growth of trade within agreements is significantly greater than growth outside of India's trade agreements? Might specific sectors in India have suffered due to a surge in imports from its partner countries?

An examination of disaggregated 3-digit trade data from 2007-2017 helps to identify sectors in which trade growth was faster within trade agreements than outside of it<sup>7</sup>. The data indicate that sectors in which trade within India's bilateral agreements grew 25% faster than trade with the world. The volume of trade amounted to about \$18 billion of imports and \$10.2 billion of exports in 2017. For ASEAN, the corresponding figures are \$15 billion of imports and \$26 billion of exports.

For sectors in which trade within bilateral agreements more than doubled relative to trade with the world, the volume of trade amounted to \$4.8 billion worth of imports and \$3 billion of exports. For ASEAN, the corresponding figures are \$7 billion worth of imports and \$10 billion of exports in 2017. Taken together, this amounts to \$12 billion of imports and \$13 billion of exports in 2017. From this, we can conclude that sectoral import "surges" do not exceed export "surges", and that these surges are small compared to the overall volume of trade (amounting to 6.5% of overall trade and only 3.5% of overall imports).

Overall, then, the data show that India's trade agreements do not account for an appreciably larger fraction of its goods trade deficit than they did before: trade deficits with India's bilateral agreement partners declined from 12.6% to 7.5% of the overall trade deficit between 2007 and 2017, and India's trade deficit under its one significant plurilateral agreement (with ASEAN) fell from about 9% to 6.6% of its overall deficit over the same period. Thus, India's trade agreements are neither to blame for its trade deficits, nor for the stagnant output and employment growth in its manufacturing sector, as is also sometimes alleged.

Why have India's agreements had such modest effects? One explanation for this has to do with the fact that India's agreements were relatively shallow – that they have entailed less liberalization, thus far, than one might have imagined. Importantly, most of India's agreements – with the exception of agreements with Japan and Singapore – were notified to the WTO under the Enabling Clause. This implies that unlike Article XXIV agreements, which require liberalization on “substantially all trade,” the enabling-clause-notified agreements undertaken by India were generally of a “partial scope”. The amount of liberalization undertaken varies across these agreements, but in general remains quite limited.

The agreements have also involved a range of implementation schedules, with liberalization undertaken – both by India and its partners – being phased over a number of years after the agreements were first notified to the GATT. Thus, for instance, while liberalization under the India-Japan trade agreement began in the year 2011, implementation is complete for only about 23% of the tariff lines. For 63% of the goods, tariff liberalization by India is only expected to be undertaken by the year 2021. Another 14% of goods excluded from the agreement altogether. Similarly, under the India-Korea agreement, signed in 2010, only about 8% of tariff lines had been fully eliminated prior to 2017. Over 60% of the tariff lines were to be liberalized by India only by 2017 and about 20% of tariff lines were excluded from elimination altogether. Equally, the India-ASEAN free trade agreement, which began liberalization in 2010, undertook the elimination of 9000 tariff lines – but to be completed only by the year 2016.

The trade outcomes under India's preferential trade agreements are mirrored, to some extent, in outcomes under preferential agreements in the rest of the world (see Krishna, 2014). Thus, the World Trade Report (WTR) 2011 argues that while there has indeed been a significant increase in the value of trade taking place between PTA members over time, much of this trade is *not* taking place on a preferential basis.

Consider trade in 1990 between PTA partners – this trade made up around 18% of world trade, rising to 35% by 2008 if one excludes intra-EU trade, and around 28% in 1990 rising to a little over 50% of world trade when the EU is included. In dollar terms, the value of intra-PTA trade, excluding the EU countries, rose from \$537 billion in 1990 to \$4 trillion by 2008, and from \$966 billion in 1990 to nearly \$8 trillion in 2008 once the EU is included.

On the face of it, this might suggest that a large share of world trade is taking place between PTA members. However, as the WTR importantly points out, these statistics vastly overstate the extent of preferential trade liberalization – and thus the extent of preferential trade that is taking place. Much of the trade between PTA members is in goods on which they impose Most Favoured Nation (MFN) tariffs of zero in the first place. Goods that are subject to high MFN tariffs are also often subject to exemptions from liberalization under PTAs, so that the volume of trade that benefits from preferences is – on average – quite low.

Specifically, WTR calculations indicate that despite the recent explosion in PTAs, only about 16% of world trade – in terms of the actual goods traded – takes place on a preferential basis (the figure rises to 30% when intra-EU trade is included). Furthermore, less than 2% of trade (4% when the E.U. is included)

takes place in goods that receive a tariff preference that is greater than 10%. For instance, well over 50% of Korean imports enter with zero MFN tariffs applied to them. Korea offers preferences to about 10% of its imports, but a preference margin greater than 10% on virtually none of its imports.

A similar picture emerges on exports. One of the countries that has actively negotiated PTAs is Chile, and 95% of Chilean exports go to countries with whom it has a PTA. However, only 27% of Chilean exports are eligible for preferential treatment, and only 3% of its exports benefit from preference margins greater than 10%. Taken together, the preceding statistics suggest that the extent of trade liberalization undertaken through PTAs has been quite modest, despite the large number of PTAs that have in fact been negotiated – a picture that is not altogether different from that of liberalization undertaken in Indian PTAs.

Perhaps this should not be too surprising. It is widely understood that a major factor working against trade liberalization is the political opposition of the import-competing lobbies. If this is the case, it is unclear why lobbies that oppose trade liberalization at the multilateral or unilateral level would easily support liberalization undertaken on a preferential basis. We should therefore expect that political lobbies would mostly only permit preferential agreements in which their rents were protected, either through access to partner country markets or – more simply – through an exemption of liberalization on imports of those goods that compete with their own production, suggesting complementarities between MFN and PTA tariffs.<sup>8</sup> This is similar to the Indian context, where, as we have argued, liberalization within India's agreements has been quite limited and where “exclusions” and “sensitive goods” categories are maintained in each trade negotiation.

Preference utilization is also limited by “rules of origin” (ROOs) which are formulated in the context of PTA agreements to prevent “trade deflection” (i.e., to ensure that goods that pass duty-free within the union are actually within-union goods and not produced outside). This is particularly important in the context of global production networks, which – through trade in intermediate goods – involve two or more countries in the production of a single final good. ROOs often result in far less trade liberalization than implied by the agreement, as they may raise transaction costs for firms to the degree that makes utilization of FTA preferences uneconomical. This is especially likely when margins of preference are small, as described above. Furthermore, as the number of concluded agreements increases, different ROOs in multiple, overlapping PTAs can pose an additional burden on firms.

As such, utilization of preferences can be cumbersome for a number of reasons. A recent report by Saraswat, Priya and Ghosh (2017) suggests that preference utilization under India's PTAs is only about 25%, due to a lack of information about preferences, low margins of preference, delays, administrative costs associated with rules of origin, and impediments caused by non-tariff barriers. While data on preference utilization is quite hard to come by, several surveys of trading firms suggest that preference utilization by exporting firms in Asian FTAs is not high in general; the Indian experience is not unusual. Thus, for a sample of 841 firms in East Asia, a study by Kawai and Wignaraja (2011) shows that only around 28% of exporting firms currently use PTA preferences. 36% of reporting firms in the Republic of Korea and 14% in China cited “having had no substantial tariff preference or having had no actual benefits from such” as the major reason for not utilizing the PTA preferential tariffs. Firms in the Philippines and Singapore attributed their low preference utilization to the countries' overwhelming “export concentration in electronics,” which is characterized by “low MFN tariff rates”.

### **III. Regional Comprehensive Economic Partnership – India's Withdrawal**

For much of the last decade, India was involved in negotiations over a “mega-regional” agreement -- the Regional Comprehensive Economic Partnership (RCEP). This was to be a free trade agreement between ASEAN nations and ASEAN's FTA partners and included 16 countries: Australia, Brunei, Cambodia, China, India, Indonesia, Japan, Laos, Korea, Malaysia, Myanmar, New Zealand, Philippines, Singapore, Thailand, and Vietnam – a grouping that constitutes about a third of the world's trade, with a population of 3 billion and a gross domestic product (GDP) of about \$20 trillion.

The fundamentals of the negotiating agenda of the RCEP covered trade in goods and services, investment, economic and technical cooperation, intellectual property, competition policy, and dispute settlement. Since RCEP's primary focus seems to be on trade itself, rather than on rules concerning the production of traded goods (such as labor or environmental standards), it was anticipated that agreement over RCEP might be easier to reach. However, after nearly a decade of negotiation, India announced its withdrawal from RCEP; the other RCEP countries have proceeded with the agreement in India's absence (although India still retains the option to join RCEP at will).

The lure of duty-free access to RCEP's markets, along with the opportunity to frictionlessly integrate with Asia's dynamic supply networks – and simultaneously provide domestic producers with a competitive fillip – should have been tempting. Nevertheless, India chose to withdraw because of its concerns about worsening trade balances and the potential for economic disruption. In particular, India feared that its domestic industry would be significantly challenged by competitive exports from RCEP countries, especially China. Moreover, it was claimed that RCEP did not allow sufficient protections against adverse economic contingencies.

While any government should be concerned about the disruptive implications of a trade agreement, the RCEP contains many features that mitigate the usual concerns. First, trade liberalization under RCEP has an extraordinarily long “phase-out” period of up to 20 years – surely a long-enough adjustment period for the Indian economy and its manufacturing sector. Second, in the event of “import surges” that cause commercial “injury” to domestic suppliers, RCEP allows for trade liberalization in those goods to be halted or even totally reversed for a period of three years, which can be further extended by another year, if necessary (see Appendix A.1 and A.2). Third, the RCEP, like the World Trade Organization (WTO), offers room for trade remedies such as the use of anti-dumping duties against predatory dumping of goods and countervailing duties against export subsidies used by trade partners (see Appendix A.3). Finally, in the settlement of disputes that arise in trade with RCEP members, India would be free to use the dispute settlement mechanisms of the WTO (see Appendix A.4)

The RCEP, then, provides India with a reasonable combination of economic opportunity and adjustment timelines. Unfortunately, the RCEP decision comes bundled with the China question: should geopolitical relations worsen, would greater dependence on China bring major economic and strategic risks? One could hope that trade interdependence itself would serve as a driver of peace. However, policy decisions cannot merely rest on such hopes – especially if interdependence is asymmetric, as would be the case between India and China.<sup>9</sup> For India, the border conflict with China has added geopolitical anxiety to an already vexed economic calculation over RCEP, while nourishing protectionist sentiment domestically and enabling vested economic interests to find nationalistic cover.

## **Domestic Reforms**

Lacking improved market access, India's hopes in trade rest largely upon its ability to rapidly improve its competitiveness on a wide scale. Improving trade and participation in global production networks will require a number of domestic improvements. These include improvements in domestic transport and trade infrastructure, and reforms that increase the productivity of India's stagnating manufacturing sector.

The relatively weak performance of the manufacturing sector and the reasons for its low productivity are generally well understood. Land acquisition for projects is a major hurdle. The regulatory framework one must traverse to install capital and begin production is cumbersome – getting the necessary permits from the various ministries is highly challenging. Taxes relating to domestic and foreign investors have been variable, generating unnecessary uncertainty for investors.

More broadly, Indian infrastructure clearly needs dramatic improvement. The transportation network remains weak. The quality and coverage of Indian roads lag far behind countries like China, as do India's port facilities. Energy supply, a necessary input for production, remains inadequate and unreliable. The need for infrastructural investments to support economic activity is obvious. An additional factor that has been widely recognized as an impediment to the growth of the manufacturing sector is the restrictive set of labour laws that govern employment in India. Overall, the ease of starting and doing business in India remains low, despite many recent improvements.

## **IV. Conclusions**

India's free trade agreements have had only a modest impact on its international trade, as can be seen from the data for 2007-17. The agreements can neither be credited with providing great stimulus for the Indian economy, nor can they be blamed for the widening of Indian's trade deficits or the stagnation of its manufacturing sector. This is because the agreements have, thus far, achieved only a limited liberalization of trade. Integrating more substantially with the global economy through agreements such as RCEP may provide significant economic opportunities, but will also bring some economic and geopolitical risks, which Indian policymakers seem disinclined to accept. Lacking greater market access and external integration, India's hopes in trade will have to rest more substantially on its ability to achieve domestic productivity improvements.



## Appendix

### A.1. Application of Transitional RCEP Safeguard Measures (Article 7.2)

1. If, as a result of the reduction or elimination of a customs duty under this Agreement, an originating good of another Party or Parties collectively is being imported into the territory of a Party in such increased quantities, in absolute terms or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to its domestic industry producing a like or directly competitive good, the importing Party may, to the extent necessary to prevent or remedy the serious injury to its domestic industry and to facilitate its domestic industry's adjustment:
  1. (a) suspend the further reduction of any rate of customs duty provided for in this Agreement on the originating good; or
  2. (b) increase the rate of customs duty on the originating good to a level not to exceed the lesser of:
    1. (i) the most-favoured-nation applied rate of customs duty in effect on the day when the transitional RCEP safeguard measure is applied; or
    2. (ii) the most-favoured-nation applied rate of customs duty in effect on the day immediately preceding the date of entry into force of this Agreement for that Party.

### A.2. Scope and Duration of Transitional RCEP Safeguard Measures (Article 7.5)

1. No Party shall apply a transitional RCEP safeguard measure:
  1. (a) except to the extent, and for such time, as may be necessary to prevent or remedy serious injury and to facilitate adjustment;
  2. (b) for a period exceeding three years, except that in exceptional circumstances, the period may be extended by up to one year if the competent authorities of the Party that applies the transitional RCEP safeguard measure determines, in conformity with the procedures specified in this Article, that the transitional RCEP safeguard measure continues to be necessary to prevent or remedy serious injury and to facilitate adjustment and that there is evidence that the domestic industry concerned is adjusting, provided that the total period of application of a provisional and transitional RCEP safeguard measure, including the period of initial application and any extension thereof, shall not exceed four years. Notwithstanding this provision, a Least Developed Country Party may extend its transitional RCEP safeguard measure for an additional period of one year; or
  3. (c) beyond the expiration of the transitional safeguard period.

### **A.3. ANTI-DUMPING AND COUNTERVAILING DUTIES - General Provisions (Article 7.11)**

1. The Parties retain their rights and obligations under Article VI of GATT 1994, the A.D. Agreement, and the SCM Agreement. This Section affirms and builds on those rights and obligations.

### **A.4. Article 19.5: Choice of Forum**

1. Where a dispute concerns substantially equivalent rights and obligations under this Agreement and another international trade or investment agreement to which the Parties to the dispute are party, the Complaining Party may select the forum in which to settle the dispute and that forum shall be used to the exclusion of other fora.

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## NOTES

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1 In somewhat of a reversal of its longstanding commitment to multilateral rather than bilateral approaches to trade liberalization, the US signed the Canada-US Free Trade agreement in 1988, which was subsequently expanded to form the North American Free Trade Agreement by including Mexico.

2 For a comprehensive economic analysis of the relevant issues in the economic and political analysis of preferential agreements, see Bhagwati (1993), Panagariya (2000) and Krishna (2014).

3 As will be discussed in greater detail later in this paper, most of India's agreements have been notified to the WTO under the Enabling Clause; the only exceptions being the agreements with Japan and Singapore.

4 Any skeptics should recall that India ran large current account deficits even as it implemented highly restrictive trade policies prior to the 1990s.

5 We should note that many countries have individual agreements with India and are also part of a separate plurilateral agreement. Thus, Singapore has its own trade agreement with India and is also part

of the India-ASEAN free trade agreement. Goods are free to be imported or exported under whichever agreement gives them “better” treatment.

6 Note that the trade balance share of APTA countries seems to have increased substantially. This is true. However, preferences within APTA are extremely modest. The increase in the trade share reflects the increased imbalance in trade with China (even in the absence of trade preferences).

7 Trade statistics are organized using various numerical coding systems. The longer the string of digits, the greater the degree of specificity of the commodity. One or two digit numbers represent greatly aggregated data for broad categories of commodities. Seven or ten digit numbers represent fairly specific commodities.

8 Baldwin and Seghezza (2010) examined correlations between MFN and PTA tariffs at the 10-digit level of disaggregation for 23 of the top exporting countries within the WTO (for which data was available) and find that MFN tariffs and PTA tariffs are complements, since the margin of preferences tends to be low or zero for products where nations apply high tariffs. The implication is that we should not expect liberalization that is difficult at the multilateral level, to necessarily proceed easily at the bilateral level.

9 China’s share in India’s trade (especially India’s imports) is quite significant, while India’s share in China’s trade is rather low. India also depends heavily on Chinese electronics exports as well as inputs for its pharmaceutical industry.